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05-05-115  
**FOLEY LARDNER**

ATTORNEYS AT LAW

WISCONSIN PUBLIC SERVICE  
COMMISSION

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October 11, 2002

**VIA HAND DELIVERY**

Ms. Lynda L. Dorr  
Secretary to the Commission  
Public Service Commission of Wisconsin  
610 North Whitney Way  
Madison, WI 53707-7854

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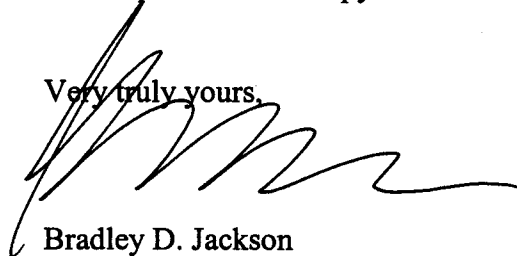
TELECOMMUNICATIONS  
COMMISSION

Re: Docket 05-US-115

Dear Ms. Dorr:

Enclosed please find the original and 15 copies of the Reply Comments of CenturyTel, Inc. in Docket 05-US-115, *Accounting Treatment for Patronage Capital by Telecommunications Cooperatives*. Please file stamp the extra copy and return it to the messenger.

Very truly yours,



Bradley D. Jackson

Enclosures

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BEFORE THE  
PUBLIC SERVICE COMMISSION OF WISCONSIN

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Accounting Treatment for Patronage Capital  
by Telecommunications Cooperatives

Docket No. 05-US-115

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**REPLY COMMENTS OF CENTURYTEL, INC.**

**SUMMARY**

CenturyTel, Inc. ("CenturyTel") submits these reply comments in the above-captioned docket in response to the comments issued by other participants in this proceeding. The initial comments reveal broad areas of agreement regarding the basic theory of patronage capital. Specifically, all commenters agree that:

- a cooperative's patronage capital is the margin collected from its ratepayers/members, reflecting that portion of rates collected that are above the actual costs of service;
- cooperatives have a legal obligation to return patronage capital to members;
- cooperatives are not taxed on patronage capital;
- cooperatives are required to operate on a non-profit basis; and
- the bylaw provision upon which the Commission has focused is a critical lynchpin to cooperatives' privileged tax status.

Initial commenters, other than CenturyTel and the Wisconsin Cable Communications Association ("WCCA"), have further claimed that placing patronage capital in Account 4520 [Additional Paid-in Capital] could create problems for a cooperative's provision of core services to its members. This could lead to a "worst case" situation in which the Internal Revenue Service ("IRS") could assess income taxes at corporate tax rates upon patronage capital. See Comments of Wisconsin Federation of Cooperatives ("WFC"), at 10.

In addition, one party (WFC) takes the position that patronage capital should be considered retained earnings for purposes of the cross-subsidization statute, Wis. Stat. § 196.204. The Rural Telephone Finance Corporation (“RTFC”) and Small Company Committee indirectly support that view. Other commenters are silent on this question [Professor Cropp (“Cropp”) and Rural Utility Service (“RUS”)] or take the opposite view [CenturyTel and WCCA].

CenturyTel has no interest in interfering with the cooperatives’ ability to provide services to their members. However, CenturyTel strongly opposes any action by the Commission which would designate patronage capital as retained earnings. That would allow cooperatives to use pre-tax dollars (generated from telephone users in a service territory protected from competition by the Commission and protected from taxation by cooperative status) to subsidize service to non-members. Indeed, Wisconsin Statutes forbid the use of patronage capital for subsidization. *See* Section 185.45 (mandating that patronage capital is legally obligated to be returned to members and not treated as retained earnings) and Section 196.204 (forbidding subsidization of affiliates with anything other than retained earnings). The Commission’s *Chibardun* Order is entirely consistent with Wisconsin law and the public policy it protects. *See Investigation of Possible Improper Subsidization by Chibardun Telephone Cooperatives, Inc. of Its Subsidiaries and of Possible Related Violations*, Docket No. 1090-TI-100 (Nov. 16, 2001).

The key question for the Commission is not finding the right account for patronage capital; the key question is whether or not patronage capital constitutes retained earnings under Wisconsin law. Substantive law directs accounting standards, not the other way around. The new accounts proposed by the cooperatives could create such a reversal by their proposed titles – “Retained Earnings-Patronage Capital Unassigned” and “Retained Earnings-

Patronage Capital Assigned.” Additional Paid-In Capital (Account 4520) is an appropriate classification for patronage capital in that it clearly distinguishes patronage capital from retained earnings. The Commission could also consider classifying patronage capital under Account 4540 [Other Capital]; or it may consider creating new accounts for patronage capital. No matter what action it takes, however, the Commission must make it explicit that patronage capital is not retained earnings and cannot be considered as retained earnings for purposes of Wis. Stat. § 196.204. The Commission should not use subaccounts of Account 4550, Retained Earnings, for this purpose, as WFC and RUS have suggested, unless those accounts are clearly renumbered and designated for Wisconsin Commission and statutory purposes as not being subaccounts of Retained Earnings. For purposes of providing reports to the Commission and verifying compliance with Wis. Stat. § 196.204, it is appropriate for the Commission to require that patronage capital be classified in a properly designated account, even if these are distinct from reports filed with RUS.

These reply comments will first address the broad areas in which all commenters agree, then highlight the areas of difference, then offer suggestions for further Commission action and finally will consider and respond to individual assertions made by certain commenters.

#### **I. Broad Agreement on Theory of Patronage Capital**

Commenters generally agree that patronage capital is “actually a price adjustment on the member’s earlier business with the cooperative.” Cropp, at 2. Commenters further agree that cooperatives “must allocate margins to members in order to legally function as cooperatives.” RTFC, at 1. Indeed, this “return of patron’s capital is fundamental to co-operative ‘operation on a cooperative basis’” as required by the IRS. WFC, at 4.

Commenters further agree that cooperatives are required to provide service to members at cost and to operate on a non-profit basis. *See, e.g.,* WFC, at 6 (“cooperatives are typically organized under not for profit statutes” and serve “groups of individuals who have come together to attain a service at cost”) (emphasis in original).

In addition, all commenters agree about the centrality of the key bylaw provision to existence as a cooperative. As WFC states, this “standard language appearing in virtually all telephone cooperatives’ bylaws regarding the excess collected over cost . . . is derived in part from federal income tax requirements, and from cooperative principles that have lasted over 100 years.” WFC, at 6. RUS “recommends that the bylaws of an RUS cooperative clearly state that the amount paid in excess of costs and expenses of providing service are furnished as capital.” RUS, at 2. The bylaw language “evolved over the years,” is “accepted as sufficient” by federal courts, and “ensures that capital credit allocations can be excluded as ‘qualified’ patronage dividends for federal income tax purposes.” WFC, at 8. “The bylaw at issue is fundamental to accounting treatment [and] is the legal framework by which co-ops raise capital, operate on an at-cost basis and return revenues in excess of costs to the members who own the cooperative.” WFC, at 11 (emphasis in original).

In sum, the requirements regarding patronage capital found in cooperatives’ bylaws are not there by chance. Rather, the bylaw is at the heart of what it means to be a cooperative, providing at-cost service to members, thus operating on a non-profit basis and thus earning the right to avoid federal taxation.

## **II. Patronage Capital Cannot Be Retained Earnings**

Given that cooperatives must provide services at cost and must operate on a non-profit basis, and considering Wisconsin Statutes and the purpose of Section 196.204, it is clear that the Commission correctly concluded in the *Chibardun* Order that patronage capital is not

retained earnings. WFC has even admitted that the “limitation in s. 196.204 simply fails to recognize that **cooperatives have no retained earnings** – all revenues (‘margins’) that exceed costs are assigned to members and are eventually paid out to members in accord with other law.”

WFC, June 4, 2002 letter, at 8 (emphasis added).<sup>1</sup>

#### A. Cross-subsidization Theory

There is a basic theory behind the limits placed on cross-subsidization. At heart, the Legislature and the Commission do not wish to see the dollars paid by captive ratepayers transferred into for-profit enterprises unless those dollars represent retained earnings, *i.e.* represent that portion of the amount of revenues in excess of cost which would properly be retained by a corporation’s shareholders.<sup>2</sup> It is not appropriate to risk ratepayer dollars in this manner, as the ratepayers could be financially harmed and see higher rates if the risky venture fails. Using ratepayer dollars for competitive ventures is also unfair to competitors, including incumbents whose own ratepayers will suffer the consequences of unfair competition.

A utility corporation pays taxes on such retained earnings. In the cooperative setting, in contrast, ratepayers are equally captive to the cooperative, but the cooperative does not pay taxes on margins. The unique abilities of cooperatives to generate non-taxable margin from captive ratepayers should not be used to subsidize competitive telecommunications enterprises

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<sup>1</sup> RUS similarly requires segregation of patronage capital “from traditionally recognized retained earnings that would be found in a balance sheet of a for-profit business entity.” RUS, at 2.

<sup>2</sup> The act creating the cross-subsidization statute, Section 196.204, describes “the intent of the legislature that: . . . the public service commission ensure that, in general, users of regulated telecommunications services and facilities pay only reasonable and just charges for such services and facilities and that such charges do not include costs associated with the competitive activities of telecommunications utilities.” 1985 Act 297, §1. For a cooperative which is required to operate on a non-profit basis and return margins to members so that service is provided at cost, its rates should not be set so high as to generate a surplus for use in competitive activities serving non-members.

that provide services to non-members outside of the cooperative's service territory. Accordingly, Wisconsin law prohibits such subsidization.

There is great harm from such subsidization. In the service territories in which cooperative affiliates operate, including those CenturyTel territories in which Chibardun's affiliate operates today, subsidized service offerings can be used to undercut incumbent service providers who are the providers of last resort. The harm caused by such subsidized competition can be felt throughout the incumbent's service territory, whether or not the competitive cooperative affiliate provides service in all portions of that territory. The fixed costs of the incumbent must be spread over a smaller number of subscribers. The highest cost customers likely will never be offered service by the competitive cooperative affiliate. The result could be increased rates or even abandonment of service in certain areas by incumbents.

The suggestion that only cooperatives will provide advance services to rural Wisconsin is without foundation. *See, e.g., RTFC*, at 3 ("residents of rural Wisconsin will be deprived of telecommunications services, such as high speed data and video, [and] absentee-owned service providers will be able to reap the monopoly profits without fear of competition and without the need to invest in modernized facilities"). CenturyTel, in fact, has made substantial investments in its territories to improve its infrastructure and facilitate the introduction of advanced services, which are now widely available. For example, since the beginning of the year 2000, CenturyTel has invested over \$230 million in its telecommunications infrastructure in Wisconsin. Over 47 million of that was invested in the deployment of more advanced services such as the replacement of switches, deploying ADSL, voice mail and on improvements and updates to its fiber optic network. Additionally, over 65% of CenturyTel's

access lines are now capable of receiving ADSL services. Further, cable, satellite and wireless companies are all involved in bringing advanced services to rural areas.

CenturyTel takes its obligation as a provider of last resort seriously and has no intention of abandoning its customers or see them fall behind in the information age. However, even the best provider of service will find it difficult, if not impossible, to compete in the long-run with subsidized competitors.

#### **B. Accounting Treatment**

The most important aspect of the Commission's decision in this proceeding is not the narrow question of which account should be used for patronage capital. Rather, the important question is whether or not the Commission's decision that patronage capital is not retained earnings should be reversed. As discussed above, any such reversal would be detrimental to Wisconsin consumers, would be contrary to statute and would be inconsistent with the basic theories of patronage capital and operation on a cooperative basis.

However, the Commission must still answer the question of which account is the proper home for patronage capital. When seen in the light of the Wis. Stat. § 196.204 treatment of retained earnings, the appropriate account would be either Account 4520 [Additional Paid-in Capital] or, perhaps Account 4540 [Other Capital]. If, however, the Commission would feel it more appropriate to use the accounts suggested by RUS, Account 4550.4 [Patronage Capital-Assignable] and Account 4450.5 [Patrons Capital Credits Assigned], it should only take such action if the accounts are renumbered to indicate that they are not subaccounts of Retained Earnings. This would clarify that such accounts cannot, will not and must not be considered "retained earnings" for purposes of Wis. Stat. § 196.204. To fulfill its statutory obligation to enforce Section 196.204, the Commission cannot allow patronage capital to be deemed retained earnings or to be included in a retained earnings subaccount.



### **III. Additional Comments**

#### **A. Utility Operations**

Several commenters have made comments such as the following: “Utilities should not need this capital since their rates, by definition, recover their costs, including reasonable levels of capital for investment in plant.” *See* Cropp, at 1. This betrays a basic misunderstanding of the importance of the financial strength of a utility’s capital structure. While that financial strength is, in part, directly related to the cash flow generated from ratepayers, the equity level within the utility is an equally important measure of financial strength. The cooperatives wish to have the ability to siphon off all of that equity into affiliated operations. This would cause direct harm to the long-term financial health of the utility and thus should be of concern to the Commission. *See, also*, Initial Comments of CenturyTel, at 11-12 (regarding capital structure).

#### **B. Other States**

The RTFC has stated that it is aware of “no other states besides Wisconsin in which regulators have issued or proposed rules that treat patronage capital as anything other than retained earnings.” RTFC, at 3. But consider that there is perhaps no other state that has a statutory provision akin to Wis. Stat. § 196.204. The question of whether or not patronage capital is retained earnings is of vital importance in creating a level playing field for competition in Wisconsin. It may be irrelevant elsewhere, but it is a fundamental aspect of telecommunications utility regulation here. And, if any other state ever had occasion to ask whether patronage capital is retained earnings, it would surely come to the same conclusion the Commission reached in the *Chibardun* Order. *See, e.g.*, K.S.A. § 17-7501 (Kansas statute noting that “retained earnings” does not include “any moneys which have been allocated and are payable to the members of any corporation which is organized as a cooperative”).

The Commission has the authority and the obligation to see that Wisconsin statutes and its rules are implemented. This includes the authority to establish a different accounting treatment for patronage capital, or any other account, for regulatory purposes even if it differs from the FCC or other state regulatory jurisdictions. In making the determination on the proper treatment of patronage capital, the Commission should hold firm to its decision in the *Chibardun* Order that patronage capital cannot be treated as retained earnings under Section 196.204.

**C. Miscellaneous**

WFC, at page 13, discusses treatment of non-member income as retained earnings. The Notice of Investigation noted that Nelson Telephone Cooperative's bylaws include a provision explicitly allowing this. WFC suggests that it would be arbitrary and capricious to treat these retained earnings differently than a non-cooperative's retained earnings. But the Commission has not proposed such disparate treatment. Since non-member income is not considered patronage capital in the first instance, it was not affected by the *Chibardun* Order or the subsequent actions of staff. (Note, however, that the appropriate legal status of non-member income generated from activities that were illegally subsidized from patronage capital is an open question.)

WFC, at 14, draws a false comparison between cooperatives and other corporate forms such as limited liability companies ("LLCs"). Only cooperatives are allowed to build up pre-tax patronage capital. Only a cooperative can use all its margins without any regard to the taxes its owners will have to pay on its income. As the Commission has recently recognized in CenturyTel rate cases, income of LLCs is attributable to their owners in the year it is generated; but cooperative members never pay taxes on patronage capital until actual distributions are made, perhaps ten or more years after the margin is actually generated. Further, while a C-

corporation's board can choose to retain earnings in the enterprise forever, a cooperative is required to return margins to members.

**D. Historical Purpose**

The WFC wishes to continue the "legal and accounting practice which has been in place for decades for cooperatives." WFC, at 14. But historical accounting practices cannot be the only guide for the Commission in this proceeding. Historically, cooperatives could only serve their own members and could not provide telecommunications service to residents outside their service territory. Since non-cooperative ILEC service territories in Wisconsin have begun to be opened up for competition, the cooperatives actually are asking for something entirely new. If their requests regarding patronage capital are granted, they will be able to operate today at cost plus an amount required to subsidize service to non-members, undercut the competition with affiliates subsidized with pre-tax dollars, and all the while maintaining their own protected service territory. In this new era of competition, the use of pre-tax dollars and the cooperatives' protected tax status should not be twisted for such purposes.

The cooperatives' claim that they must be allowed to subsidize competitive enterprises or else advanced services will not be made available to rural Wisconsin is false. Nothing stops a cooperative from using its patronage capital to finance infrastructure improvements to deliver advanced services to its own customers. The cooperatives' effort to have patronage capital classified as retained earnings has nothing to do with the services they provide their own customers. It has everything to do with the cooperatives' desire to profit from the provision of subsidized competitive services to non-members in ILEC service territories. At least in the case of CenturyTel, advanced services are already available in these territories. Cooperative subsidization is not needed.

Cooperatives have been created and been provided special treatment for the purpose of serving their members. Thus they lose credibility when they complain about being placed at a "dramatic competitive disadvantage." WFC, at 14. There are no telecommunications competitors who are allowed to serve their members. And they were not created to serve non-members. Thus, there is no disadvantage. There is only the substantial benefits, and the clear limitations, that flow from being a cooperative. If cooperatives really want to compete on a level playing field, then they should open their territories to competition and play by the same rules as the other competitors.

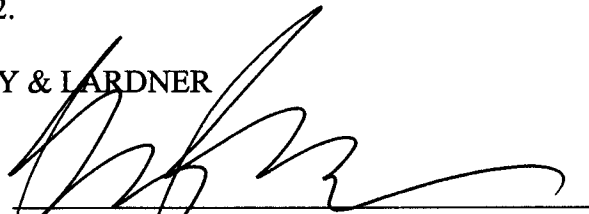
**IV. Conclusion**

CenturyTel thus respectfully requests that the Commission only take action in this docket that will support its determination in the *Chibardun* Order that patronage capital is not retained earnings, particularly for purposes of Wis. Stat. § 196.204.

Dated this 11th day of October, 2002.

FOLEY & LARDNER

By

  
\_\_\_\_\_  
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05-US-115

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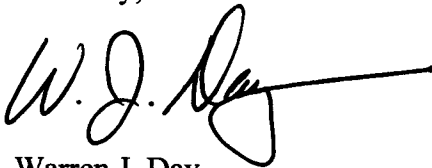
Ms. Lynda Dorr, Secretary  
Public Service Commission  
P. O. Box 7854  
Madison, WI 53707-7854

Re: 05-US-115 - Accounting Treatment of Cooperative Patronage Capital  
Joint Comments of the Wisconsin State Telephone Cooperative Association and  
the Wisconsin Federation of Cooperatives

Dear Ms. Dorr:

Attached for filing are 15 copies and one original of the reply comments of WSTCA and  
WFC in the above-referenced docket.

Sincerely,



Warren J. Day  
Attorney for  
WSTCA and WFC

MFC  
COB  
ALJ  
OGC2  
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BEFORE THE  
PUBLIC SERVICE COMMISSION OF WISCONSIN

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Accounting Treatment of Patronage Capital  
by Telecommunications Cooperatives

05-US-115

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**Joint Comments of the Wisconsin State Telephone Cooperatives  
Association and the Wisconsin Federation of Cooperatives**

**Introductory Comment**

The issue in this investigation is whether the PSC will curb the non-utility activities of Wisconsin telecommunications cooperatives (and only cooperatives) through an accounting order. The present accounting practice, which co-ops ask to continue (with precise definition), has been in use for decades under PSC supervision, and under settled state and federal law. The "playing field" is already level.

CenturyTel (CTL) and the Wisconsin Cable Communication Association (Cable) have submitted only unsupported legal theories and error-filled descriptions of cooperative law and practice. The whining about cooperative advantages dates back to the 1930's and before, when investor-owned utilities (IOUs) opposed passage of the Rural Electrification Act and the creation of cooperatives to form and serve rural patrons.

Nothing in s.196.204 distinguishes cooperatives from other regulated telecommunications firms. The legislative intent must not be inferred; the statute must be applied as written. The PSC should not enact a different application of s.196.204 for cooperatives through accounting rules.

Co-ops are customer owned and thus are governed and operated differently, but without distinction from investor-owned firms under the statutes. Despite the cooperative differences, the same statutory framework applies to all Wisconsin telecommunication firms. It is significant that the small telephone companies (WSTA committee) support the cooperatives' position, as does the RUS, and the National Rural Telephone Cooperative Finance Corporation.

Co-op members and their elected directors regulate the rates and retains instead of the PSC-W. s.196.37(4), stats. Still, telephone cooperatives' rates are in line with other regulated firms. Their retained earnings have not been excessive (which would be illegal under cooperative law) and the PSC has shown it has the authority to control cross-

subsidies that exceed retained earnings. CTL's rate of customer complaints is seven times higher than for the co-op ILECs.<sup>1</sup> If not-for-profit status had any real advantage, CTL and cable companies would convert to cooperative status. In fact, under the procedures of s.196.11(3), stats., CTL ILEC affiliates can easily sidestep taxes and adopt non-for-profit status exactly like that of a cooperative.

### Reply To CenturyTel Comments<sup>2</sup>

One CTL statement (CTL, page 13) is outrageous: that competition from cooperatives supposedly may cause ILECs like CTL to abandon service in rural Wisconsin exchanges. This is an affront to CTL ratepayers and to lawmakers who want more competition in telecommunications services, not less. CTL may be "rural" under the 1996 Telecommunications Act, but it still serves several cities in Wisconsin and is the second largest ILEC with 495,000 access lines. (That is over 100 times larger than the average telephone co-op in Wisconsin.) The threat is betrayed by the fact that CTL continues to buy in Wisconsin and elsewhere.<sup>3</sup>

(CTL, page 3) Too much is made of the record in Chibardun. The first Chibardun bylaw does not stand for the proposition that patronage capital amounts are to be placed in "additional paid-in capital." To the contrary, they are charged to a patronage capital account that will eventually be redeemed to the members in the form of a cash redemption.

As explained previously, the second bylaw recognizes that in the course of normal business, certain margins will be derived from non-patronage sources, hence it is designated as "unallocated retained earnings" in the bylaws. CTL's diatribe on this bylaw reflects an unwillingness to acknowledge the fact that cooperatives follow different procedures and are governed differently than investor-owned firms. The second bylaw has not been adopted by 9 of 11 cooperatives, and all net proceeds from any source are

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<sup>1</sup> Source: PSC Div. of Water, Compliance and Consumer Affairs for the period 1-1-01 to 10-1-02.

<sup>2</sup> CTL's comments overflow with hypocrisy. The company acknowledges competition from CLECs, "particularly in high population areas," and later says it will continue to actively monitor legislative and *regulatory initiatives that may give rise to new business opportunities*. CTL 2002 SEC Form 10K [Emphasis added. Perhaps this docket is such an opportunity.]

CTL is hardly a victim of unfair competition. Trading on the New York Stock Exchange as "CTL", the firm has over three million customers in 22 states. In August CTL sold its wireless properties for a mere \$1.65 billion, and used the cash to finance the purchase of even more Verizon properties in Alabama and Missouri. On top of that, CTL is a huge RUS borrower, and boasts lines of credit of \$123 million from RUS and the Rural Telephone Bank as of 12-31-01. (From press releases, 2001 Annual Report to stockholders, and 2002 SEC Form 10K report.)

The company's 2002 Annual Report cites the "ability to successfully introduce new offerings on a timely and cost effective basis, including ... its long distance and internet offerings to new markets ... bundled service packages ... and initiate competitive local exchange and data services in its targeted markets. CTL purchased Verizon properties in Wisconsin knowing there is competition for traditional landline service, especially in these badly served areas. It is a safe assumption that the Verizon properties came at a significant discount.

<sup>3</sup> CTL 2002 SEC Form 10K Report, *supra*.

allocated to patrons by those cooperatives. The reason for creating "Unassigned" and "Assigned" subaccounts for patronage capital is not a nefarious scheme. It is a matter of timing between the close of the accounting year and when patronage margins are, by law, assigned in the next year. Again, this is fundamental to decades of practice under the Internal Revenue Code. Any change of these bylaws jeopardizes tax and cooperative status under the Code. CTL does not understand cooperative law, or perhaps it merely objects.

(CTL, p.5-6) CTL is simply wrong in its claim (top of page 6) that calling a portion of patronage capital "retained earnings" would violate cooperative law. In a cooperative, members have "vested property rights" which are predicated on patronage, even for margins retained by the cooperative. Hence, upon liquidation of a cooperative, after all debts, member certificates, and allocated patronage credits have been paid, any remaining amounts are distributed on the basis of historic patronage of each member, including any retained earnings. Further, IRS Revenue Ruling 72-36 (a WSTCA exhibit) authorizes a co-op to maintain reasonable reserves so long as the co-op maintains records to determine the members' interests in those reserves. CTL does not understand cooperative law.

#### Re Tax Status and Non-Profit Status

The following comments correct the mistaken notion that cooperatives hold an unfair competitive advantage by virtue of tax status.

(CTL, page 6) CTL seems not to realize that a change in the computation of the 85 percent member income test was imposed by the IRS - which then changed most telephone cooperatives' tax status. A co-op's tax status is often not known until after the close of the year, when income is computed by source. A cooperative can easily be taxable one year, and tax exempt the next. The tax status is often not constant, or predictable.<sup>4</sup>

There is no significant advantage in tax exempt status because co-ops ultimately pay all net proceeds back to members. Co-ops cannot "build capital" because retained earnings are limited by the members' and by the IRC. Rev. Rul. 72-36<sup>5</sup> Furthermore, whatever is retained is typically paid-out (revolved) by board decision in 8 to 12 years (it varies by co-op). For these reasons, proceeds cannot accumulate. If there was any significant advantage in tax -exempt status, IOUs would elect to avoid tax and pay out surplus profits to ratepayers under s.196.11(3), stats.

(CTL page 10-11) CTL's statement of law relating to Unrelated Business Income under sections 511-514 of the IRC is incorrect. It is true that if an exempt organization engages in an activity outside the scope of their exemption, they will pay tax at a corporate rate. However, CTL's statement about the formation of for-profit subsidiaries is completely

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<sup>4</sup> In the Initial WSTCA/WFC filing, we indicated that 10 of 11 ILEC cooperatives were tax exempt. That may be too high. The tax status may have changed (or changed back) for one or two others. At the time of this filing, we are uncertain.

<sup>5</sup> Also see the Tax Management portfolio excerpt submitted previously as an exhibit.



wrong. There are literally thousands of tax exempt entities that have for-profit subsidiaries. In Revenue Ruling 2002-55 (discussed in the WSTCA initial comments) the IRS said that there would be no attribution of income of for-profit subsidiaries to exempt telephone cooperatives until dividends were actually paid. CTL merely objects to the Internal Revenue Code.

(CTL, page 11-12 re capital structure) The cooperatives' use of net proceeds is a matter always left to the discretion of the board of directors. It has been so under the current accounting practices in place for decades per PSC directive. (See the co-ops' response to issue 7 in initial comments, and the related exhibit.) The co-ops propose only to restore two subaccounts explicitly for patronage capital. PSC oversight of the debt-equity ratio of cooperatives has been unnecessary. IOUs generally have higher equity levels (cash from rates) than co-ops - which may average about 30 percent equity, and 70 percent (low interest) debt. If desired, the elected cooperative board can invoke PSC oversight under s.196.205, or co-op members can do so by a petition of only five (5) percent of members under s.196.26(4), stats. So there is triple protection against neglect of core utility functions. Neglect of the utility is more evident in IOU utilities, where anonymous shareholders lack a voice, or where there is pressure on management to produce for short-term profit.

(CTL page 12) CTL claims "true" equity capital (the term is not defined) of a cooperative is something "much less" than retained earnings. This is a baseless claim - and it is wrong! The cooperative's capital structure is *already* almost entirely built from retained earnings - in use during the revolvment cycle pending refund.

CTL asserts that patronage capital used as retained earnings could affect capital structure. CTL is confused. The equity of a cooperative is *primarily* patronage credits - retained over the years to build-up the cooperative. This is the established, legal practice for a hundred years! As long as the net proceeds remain reasonable in the judgment of the directors, democratically elected by the member-customers, outside investment is both permissible and necessary to grow and compete. (See Letter of Prof. Cropp) The reclassification of retains to additional paid-in capital will only harm the cooperatives and their viability - because funds for advancements in services and diversification to match competitors will be "reclassified" (read: eliminated) by the PSC.

#### Reply to Comments of Cable Association

**The cable companies' comments foster the misunderstanding** that "cooperative status prohibits use of patrons' funds for resources to subsidize a competitive entry in a non-regulated marketplace" [sic]. (Cable, p.3). The term "subsidy" is ambiguous as Cable has used it. Clearly cooperatives can and have used net proceeds (i.e., retained earnings) to diversify. They do so legally under the IRC, state law and PSC accounting system. What they are not permitted to do is cross-subsidize in excess of retained earnings per s.196.204(1). The harmful effect of the PSC reclassification of retained earnings (Albino letter of 12-17-01) would be to drain away the retained patronage capital to the

inaccessible account 4520. This would be overkill - the PSC already has the tools to control excessive cross-subsidies.

Under longstanding arrangement, the members' patronage capital is the primary source of investment equity. *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305 (1965); also *Rev. Rul. 72-36*, a filed exhibit.) Regulations to disrupt that primary source of equity could disable the cooperatives, and jeopardize past and future investments, including loans from others.. (See RTFC comments.)

Cable companies (page 5) confuse or misrepresent the effect of the second bylaw (Nelson and Chibardun only) as if it applied to all ILEC cooperatives. The operation of the bylaw adopted by all the cooperatives has been correctly described in previous filings of WSTCA/WFC and will not be reviewed again here.

**Nearly all other parts of the Cable comments are grounded in the misrepresented status of retained patronage capital. No further effort will be made to correct the distortion.**

#### The Relevance of Chapter 185

CTL and Cable interpret s.185.45 as requiring every cooperative to pay to patrons every cent in excess of the cost of operation - and that is precisely what they do under the (first) bylaw, the statute and the PSC rules (see the exhibit PSC USOA of 1977). The accounting change ordered in Chibardun was the first departure from that practice, forcing one, and almost ten more ILEC cooperatives into uncharted legal territory.

It is the design of chapter 185 (and the cooperative enabling statutes of all states) to allow the retention of net proceeds as the primary source of equity capital, use the retains, and return (revolve) to members later. Profit or non-profit status is merely a taxation issue, not a limitation on the kind of investments which may be made. (That limitation is imposed by the IRS which requires "like activities" to the tax exempt purpose, but only to qualify for tax exemption. See our initial response to issue 6 and the discussion of Revenue Ruling 2002-55.)

In summary, Chapter 185 leaves to the members and their elected directors the decisions on how margins are to be used. The PSC should not use an accounting device to re-write 185.45 and 196.204.

#### Response to RUS Comments

We are compelled to address some of the statements of the RUS because the lack of clarity invites further misunderstanding of the patronage capital bylaw. First, on page 1, RUS incorrectly says "the tax code requires that a cooperative return these capital credit allocations, in cash, to the members within a reasonable period of time after the close of the fiscal year, [but] utility cooperatives have been granted an exemption." In fact, the code does not require any cooperative to return its margins; Subchapter T cooperatives

IRC s.1388 (c) (1) do have to provide at least 20 percent in cash in order to claim a deduction. Telephone cooperatives, whether exempt or non-exempt, do not have to return cash to in order to exclude patronage dividends from income.

Second, on page 2, the agency says "patronage capital ... is a combination of capital stock and retained earnings". This is somewhat misleading. Telephone cooperatives are generally (not always) not stock cooperatives, so stock does not exist in the telephone cooperative capital structure. Therefore the use of accounts related to capital stock (including account 4520) by telephone cooperatives is not appropriate. (See Strait comments in 10-1-02 initial filing)

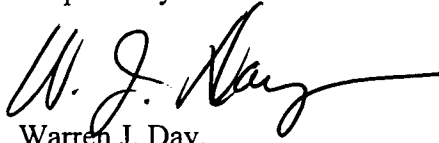
Third, RUS' description of accounts 4510 and 4520 is difficult to comprehend. To clarify, the following is offered;

Account 4510 - Capital Stock: The amount of par value paid in on the outstanding shares of stock.

Account 4520 - Additional Paid In Capital: The excess paid in on the outstanding shares of stock in excess of par value.

Keeping in mind that two-thirds of RUS borrowers are for-profit companies like CenturyTel, it is fairly clear that these accounts were included for the stock companies, not for the cooperatives.

Respectfully Submitted on October 11, 2002



Warren J. Day,

Attorney for  
Wisconsin State Telephone Cooperative  
Association, and  
The Wisconsin Federation of Cooperatives

Daniel W. Matson  
Vice President  
Regulatory and Government Affairs

WISCONSIN PUBLIC SERVICE  
COMMISSION

2002 OCT 11 A 11: 22

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October 11, 2002

Ms. Lynda L. Dorr, Secretary to the Commission  
Public Service Commission of Wisconsin  
610 North Whitney Way  
P.O. Box 7854  
Madison, WI 53707-7854

Accounting for Patronage Capital by }  
Telecommunications Cooperatives }

05-US-115

Dear Ms. Dorr,

As invited in the Notice of Investigation mailed August 26, 2002 in the referenced docket, Verizon North Inc. is filing with this letter an original and fifteen (15) copies of its reply comments. Verizon appreciates the commission consideration of these comments.

Very truly yours,



Daniel W. Matson

Enclosures

05-US-115  


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**BEFORE THE  
PUBLIC SERVICE COMMISSION OF WISCONSIN**

WISCONSIN PUBLIC SERVICE  
COMMISSION  
2002 OCT 11 A 11: 22

Accounting Treatment for Patronage Capital                    )  
By Telecommunications Cooperatives                            )

**RECEIVED**  
Docket No. 05-US-115

**REPLY COMMENTS OF VERIZON NORTH INC.**

On August 26, 2002, the Public Service Commission of Wisconsin ("Commission") posted notice of an investigation into the appropriate accounting treatment for patronage capital by incumbent local exchange carrier (ILEC) telecommunications cooperatives. Initial comments were to be filed by October 1, 2002, and reply comments were due October 11, 2002. Verizon North Inc. ("Verizon") hereby submits the following reply comments.

Verizon concurs with the comments filed by Centurytel, Inc., that the questionable accounting changes requested by the cooperatives are inappropriate. Patronage capital is not retained earnings. As the Commission correctly concluded in *Investigation of Possible Improper Subsidization by Chibardun Telephone Cooperatives, Inc. of Its Subsidiaries and of Possible Related Violations*, Docket No. 1090-TI-100 (Nov. 16, 2001) ("Chibardun Decision"), the bylaws of the cooperatives make clear that patronage capital is not part of retained earnings within the meaning of Wis. Stat. § 196.204(1). The only thing that has changed since that decision is the public revelation in recent high profile corporate accounting scandals of what can happen when abusive accounting practices are not policed. The proposal by the cooperatives to create subaccounts that would mix patronage capital with retained earnings is contrary to the bylaws of the cooperatives and would be irresponsible.

Verizon concurs with the comments of other parties that under accounting and tax rules the proposal by the cooperatives is flawed. Patronage capital is fundamentally different than retained earnings. Simply stated, patronage capital belongs to the customers of the cooperatives and must be paid back to them. Retained earnings, on the other hand, may be used at the discretion of a business. While it can be done, there is no obligation to pay retained earnings to shareholders. Cooperatives qualify for significant tax advantages through retention of pre-tax patronage capital because such funds are intended for later distribution.

However, what the cooperatives propose is not just a matter of attempting to skirt the Commission's Chibardun Decision, engaging in questionable accounting practices, playing semantics or confusing the issues. It ultimately goes to a challenge of a fundamental policy of the telecommunications regulation under Wis. Stat. Chapter 196 - to promote effective competition. What the cooperatives propose would result in exactly the opposite of what the legislators intended. The cooperative's scheme in the end would be very harmful to competition. The proposal will allow cooperatives to exploit their status as exclusive providers in their protected exchanges through cross-subsidization of their activities in other exchanges open to competition, ultimately eliminating the competitive providers there.

While the cooperatives may argue that they will add another player to the mix of competitors in exchanges that are open to competition, allowing them to use their patron's funds to provide services through cross-subsidization does not mean that competition would be served. It only means that they would unfairly have the advantage of their unique tax and financial support status as cooperatives to displace other

providers. What the cooperatives propose is to use their unique protected status to unfairly compete with carriers that are not similarly situated to eliminate competition. This proposal will only allow them to skew the playing field unfairly in their favor, and as history has demonstrated, such tactics will only replace the existing competitors with exclusive cooperative subsidized providers. The expansion of exclusive providers only erodes competition.

Furthermore, the argument made by the Rural Telephone Finance Cooperative that the cooperatives hold the future of rural broadband in their hands is nonsense. Rural technology deployment will follow the same pattern as did the deployment of other technologies such as wireless telephony. This can already be seen as new and existing vendors are moving into medium to small marketplaces with wireless broadband. To preposition cooperatives in these markets would be to discourage legitimate investors and ultimately limit the choices available. Additionally, the newer satellite broadband services are available almost everywhere.

If cooperatives want to compete outside their protected exchanges, they should do so only if the playing field is level. This means they should not be allowed to use their patron's capital as their own treasury to fund their expeditionary adventures. Once they change their nature and become competitive carriers like any other business competitor their protected exchanges should also be opened to competition. Other carriers should be provided certificates to operate in their exchanges and the cooperatives should be required to abide by the same competitive obligations of other ILECs who have opened their exchanges to competition. While Verizon does not propose such relief in this

docket, since it is probably beyond the scope of this docket, Verizon raises the issue to illustrate another reason why patron capital should not be considered retained earnings.

The Commission should also not be misled to conclude that the Wisconsin State Telephone Association ("WSTA") supports the cooperative proposal. The WSTA has not taken a formal position on this issue. There was a reference in the transmittal letter and motion that accompanied the comments of Mr. Warren Day, attorney representing the Wisconsin Telephone Cooperatives and the Wisconsin Federation of Cooperatives, that the WSTA supported the treatment of patron capital as proposed by the cooperatives. (See: September 30, 2002 Transmittal Letter and Motion of the Wisconsin Telephone Cooperatives and the Wisconsin Federation of Cooperatives to Ms. Lynda Dorr, Secretary, Public Service Commission.) It may be that the WSTA small company committee, which includes cooperatives, may support this proposal, but that is not an endorsement of the WSTA itself.

Adoption of the cooperative's proposal would be contrary to the nature of the cooperatives, is inconsistent with accounting and tax rules, and would harm competition. The proposal should be rejected.

Respectfully submitted,

VERIZON NORTH INC.

By 

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05-US-115  
**FOLEY LARDNER**  
ATTORNEYS AT LAW

October 11, 2002

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WISCONSIN PUBLIC SERVICE  
COMMISSION

**VIA HAND DELIVERY**

Ms. Lynda L. Dorr, Secretary  
Public Service Commission of Wisconsin  
610 North Whitney Way  
Madison, Wisconsin 53707

Re: Accounting Treatment for Patronage Capital by Telecommunications  
Cooperatives; Docket No. 05-US-115

Dear Ms. Dorr:

Please find enclosed for filing an original and fifteen copies of the Reply  
Comments of Wisconsin Cable Communications Association in the above-referenced matter.  
Please file stamp the additional copy and return to our courier for our files.

Thank you for your assistance in this matter. Please contact me if you have any  
questions regarding this matter.

Very truly yours,



David G. Walsh

Enclosures

cc: Thomas Hanson

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BEFORE THE  
PUBLIC SERVICE COMMISSION OF WISCONSIN

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Accounting Treatment for Patronage Capital  
by Telecommunications Cooperatives

Docket No. 05-US-115

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**REPLY COMMENTS OF WISCONSIN CABLE COMMUNICATIONS, INC.**

**SUMMARY**

The Public Service Commission of Wisconsin's ("Commission") request for comments on the appropriate accounting treatment for patronage capital by telecommunications cooperatives has resulted in two general responses. CenturyTel, Inc. ("CenturyTel") and Wisconsin Cable Communications Association ("WCCA") argue that the patronage capital should not be accounted for as a subset of retained earnings. Their arguments are supported by an analysis of the nature of patronage capital and the distinctions between retained earnings and patronage capital. The comments filed by the cooperatives and certain other commentors which argue that patronage capital should be treated as retained earnings fail completely to discuss the differences between patronage capital and retained earnings.

Professor Robert Cropp, the Director of the University of Wisconsin Center for Cooperatives, provides a scholarly description of cooperative economics and argues that classifying "patronage capital" as "additional paid-in capital" would jeopardize the major source of equity capital for cooperatives. He argues that the "dominant means of obtaining equity capital is through retained patronage refunds" and that the "patronage refund" is "actually a price adjustment on the member's earlier business with the cooperative." The theme of his comments is that patronage capital should not be classified as "additional paid-in capital." However, his

comments are solely limited to that argument. Nowhere does he discuss retained earnings or even argue that if the patronage capital is not classified as “additional paid in capital,” it should be included as retained earnings. Moreover, he misstates the Commission’s proposal when he states “the Commission’s directive to reclassify patronage capital to classify retained earnings [sic] as “Additional Pain-in Capital” [sic] would, by all indications, choke off the primary source of capital available to the Board for use in the member’s best interest.” While convoluted at best, his claim is not supported by any facts, cites or basis in the record. In sum, Professor Cropp’s comments are not relevant because they fail to focus on the threshold issue of whether patronage capital should be included as a part of retained earnings.

The comments of the Rural Telephone Finance Cooperative (“RTFC”) are limited but interesting in their unsupported claims. For example, it states that “the Commission’s actions in the Chibardun Order puts Chibardun’s cooperative status at risk.” Yet, nowhere does it explain the risk other than to claim that somehow the margins allocated to patronage may be “locked up” in additional paid in capital. These unsupported claims are of little help. The RTFC conveniently ignores the genesis of this issue. Chibardun was found to violate Wisconsin Statute 196.204(1) because it subsidized an affiliate in excess of its retained earnings. The case did not involve the raising of capital. Indeed, the RTFC was the lender to Chibardun and all it requested was a guarantee. Obviously, it was not concerned about capital and for it to now claim that the Commission’s action will “cripple” a “cooperative’s ability to raise debt capital, not only for unregulated competitive ventures but also for core ILEC improvements and extensions” is disingenuous at best. Further, its description of the “impacts” which will occur “unless the Commission reverses its position on patronage capital” strain credibility. For example, it claims that because Wisconsin law “limits a teleco’s ability to invest in subsidiaries engaging in

competitive ventures to the amount of its retained earnings” reclassifying patronage capital will reduce a cooperative’s retained earnings and therefore it will have no funds which it can legally invest in new, competitive ventures. This is not only wrong but it is insulting to the Commission’s decision in Chibardun. Unfortunately, this claim is repeated by the cooperative industry throughout its comments. The Chibardun case involved Wisconsin Statute 196.204(1) and the extent of a subsidy not whether a cooperative can invest in an affiliate. Section 196.52(8), Wisconsin Statutes governs the amount of equity a public utility can invest in affiliates without Commission approval. It allows a public utility to invest equity capital in a subsidiary in excess of the level of equity that the Commission has determined to be appropriate for the utility’s capital structure without Commission approval. This statute specifically refutes the claims of the RTFC and the cooperative industry. It allows investment of equity capital in excess of the “level of equity” determined by the Commission “appropriate for the utility’s capital structure.” It speaks volumes that the cooperative industry has never requested the Commission to make that determination. It is wrong and hypocritical for the RTFC and the cooperative industry to ignore that responsibility and claim that the Commission’s correct decision in the Chibardun Order that patronage capital is not retained earnings indirectly deprives them of the right to invest in subsidiaries.

The RTFC also claims that without equity investment by a cooperative no lender will lend to finance a competitive entry. It further claims that it has never provided 100% debt financing. The RTFC has a short memory. It admitted that it would not have financed Chibardun’s affiliate without a 100% guarantee by the parent. Indeed, the subsidy for which Chibardun was held to violate Section 196.204 involved the RTFC financing which, as admitted by RTFC, would not have taken place but for the guarantee which was required because of the

nominal equity investment by Chibardun in its affiliate. The classification of patronage capital would not have changed the underwriting analysis. RTFC's claims strains its credibility. Finally, the RTFC claims that "absent financing for the telecommunications cooperatives, residents of rural Wisconsin will be deprived of telecommunications services . . . that their urban counterparts enjoy." Of course, the RTFC provides no basis, support or factual data for this alleged impact.

The comments of the RUS are interesting in that they fail to address the distinctions between patronage capital and retained earnings and they actually concede a crucial point which the Commission relied on in Chibardun. The RUS states:

"RUS has always taken the position that assigned patronage capital represents capital contributed to the cooperatives by its members. RUS recommends that the bylaws of RUS Corporation clearly state that the amounts paid in excess of costs and expenses of providing service are furnished as capital. RUS' position that assigned patronage capital represents capital contributed to the cooperative by its members would appear to be supported by the United States Tax Court which rules that the payment of patronage dividends represents a return of capital."

This comment concedes a fundamental distinction between retained earnings and patronage capital. Patronage capital "represents capital contributed to the cooperative by its members." Retained earnings is undistributed, after tax earnings. Patronage capital belongs to its members. Retained earnings belongs to the corporation. The RUS comments support the Commission's decision that patronage capital should not be considered part of retained earnings.

The comments of the WSTA Small Company Committee do not provide any additional evidence, support or basis for changing the Chibardun Order. They merely repeat the conclusory statements regarding hardship, risk of tax status and impact on the ability to provide advanced telecommunications services without any factual basis.

The comments of the Wisconsin Federation of Cooperatives (“WFC”) focus primarily on the impact of classifying patronage capital as additional paid in capital and offer an historical tax analysis of cooperatives. Like the other cooperative industry comments, they fail to offer any analysis of why patronage capital should be considered retained earnings. Interestingly, it indirectly attempts to equate patronage capital to retained earnings by suggesting that the Commission should consider partnerships and limited liability companies more like cooperatives than C corporations. Its sole argument for this rather unusual statement is that all but a C corporation are “pass through” entities and therefore should be treated similarly. While the conclusion for this claim is not clear, what is clear is that the WFC ignores the realities of the tax impact to the recipients of “pass through” entities. A partnership, limited liability company and an S corporation must, as a practical matter, distribute at least the estimated income tax liability to the owners of such entities because they are taxed (the nature of a “pass through” entity) as if they received the income earned by the entity. On the other hand, this is not the case with cooperatives which traditionally retain the entire margin and therefore have the advantage of pretax margin as compared to a C corporation or other pass through entity which is left with after tax or after distribution income. The point is that as measured by the amount of retained earnings available for investment, the pass through entities are much more like C corporations than cooperatives which traditionally retain pretax earnings.

There is a consistent theme throughout the comments of those that would support reversal of the Chibardun Order. They basically argue, don’t change what we have been doing for a long period of time even though it might be an anachronism. The RUS even admits that “the accounting for patronage capital is not prescribed in Generally Accepted Accounting Principles; rather, it was developed by RUS and its borrowers and is, in effect, a hybrid of the

accounting that would be found in the equity section of a profit oriented entity.” Curiously, or perhaps obviously, they do not address the threshold issue of whether patronage capital should be included in the calculation of retained earnings. This was the issue in Chibardun and the Commission held, after reviewing all of the evidence and relying on the best evidence which was the cooperative’s own bylaws, that patronage capital is different from retained earnings and should not be included in the calculation of retained earnings. Yet, rather than arguing why it should be included in retained earnings, the cooperative industry ignores the threshold issue, argues it should not be included in paid-in capital and claims a litany of horrors, all of which are unsupported.

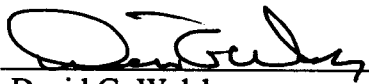
The only conclusion is that the cooperative industry simply does not want to change its accounting system although it admits that it is “not prescribed in Generally Accepted Accounting Principles.” On the other hand, it argues for the ability to compete in the unregulated marketplace. With all due respect to the cooperative industry, that is the point. If it wishes to compete in the unregulated marketplace and use assets generated by the rate payors of its regulated activities then it should, like its competitors, be governed by the same rules. If it wishes to venture into the competitive marketplace and put its assets at risk, then it should adhere to Wisconsin Statutes and the rules and regulations of the Commission. If it wishes to subsidize an affiliate, then the subsidy should be limited solely to its retained earnings. If it wishes to invest in an affiliate, it should do so only after the Commission has determined a “level of equity” . . . appropriate for the utilities capital structure.” Only then will the rate payors be protected and fair competition exist. As to the cooperative’s claim that only it can bring new telecommunications services to rural Wisconsin, the Chibardun case speaks for itself. When it choose to compete in the marketplace, Chibardun and its affiliate chose not to provide services

where services didn't exist but rather to compete against an ILEC and cable television system with similar services but at a lower price because it was subsidized. Chibardun and its affiliates had the advantage of low cost government loans, the affiliate received significant subsidies from Chibardun and the result was the same services at lower prices.

As to the fundamental issue of whether patronage capital should be considered part of retained earnings there is simply no justification or theory to do so, particularly in light of the cooperatives' own bylaws (see argument in WCCA's initial comments). Moreover, there are persuasive analogies. For example, the Internal Revenue Service does not consider patronage capital to be retained earnings when it refrains from assessing taxes on it. The cooperative's Board of Directors does not consider patronage capital to be retained earnings when it meets its statutory and bylaw obligation to return it to its members. Nor do lenders care if it is retained earnings so long as it is part of equity. Yet, the cooperatives want the Commission to consider patronage capital part of retained earnings when it decides to subsidize affiliates. The cooperative industry's argument that patronage capital should be retained earnings is Enron-style accounting, where a duck is a duck only until management needs a goose, when it becomes a goose. The Commission should have no part of it.

Dated this 11<sup>th</sup> day of October, 2002.

FOLEY & LARDNER

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